

## Internal Revenue Service

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Department of the Treasury  
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PLR-163304-05

Date:  
May 09, 2007

### Legend:

Taxpayer =

Subsidiary =

Date 1 =

Date 2 =

Notes =

Trust =

a =

b =

c =

Dear :

This is in reply to a letter dated October 24, 2005, and supplemental correspondence dated January 27, 2007, requesting certain rulings on behalf of Taxpayer. The requested rulings concern the treatment of bond issuance premium under section 856 of the Internal Revenue Code (the "Code").

## **FACTS**

Taxpayer is a domestic corporation that initially elected to be treated as a real estate investment trust (REIT) under part II of subchapter M of the Code (sections 856-859) for its tax year ending on Date 1. Taxpayer's stock is publicly traded on a national stock exchange. Taxpayer's principal activity is to invest in mortgages and mortgage backed securities.

Subsidiary is a wholly-owned subsidiary of Taxpayer. Taxpayer has represented that Subsidiary is a qualified REIT subsidiary of Taxpayer under section 856(i)(2) of the Code. Subsidiary's principal activity is to originate mortgage loans. When Subsidiary accumulates a certain amount of mortgage loans, it transfers those loans to an owner trust and issues notes in the owner trust to investors.

On Date 2, Taxpayer, through Subsidiary, issued the Notes which are secured by mortgage loans held in the Trust. All of the mortgage loans are secured by real property and are not contingent payment debt instruments.

Certain of the Notes were issued with bond issuance premium (the "Premium Notes"). The Premium Notes were issued with an issue price of a and a stated redemption price at maturity of b, resulting in bond issuance premium of c. Taxpayer represents that it amortizes bond issuance premium using a constant yield method of accounting for Federal income tax purposes.

Taxpayer represents that the Trust will be classified as a taxable mortgage pool pursuant to section 7701(i) of the Code. Taxpayer owns 100% of the beneficial interest in the Trust. The Notes are publicly offered and the stated interest and principal on the Notes are payable monthly. To the extent principal is prepaid on the underlying mortgage loans (in excess of regularly scheduled principal payments on such loans), the Trust makes additional principal payments to the holders of the Notes. Taxpayer represents that the Notes are debt instruments to which section 1272(a)(6) of the Code applies.

## **LAW AND ANALYSIS**

Section 856(c)(2) of the Code provides that in order for a corporation to be considered a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer), abatements and

refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees, and gain from certain sales or other dispositions of real estate assets.

Under section 856(c)(3) of the Code, in order for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income.

Section 1.856-2(c)(1) of the regulations provides that for purposes of both the numerator and denominator in the computation of the percentage requirements of section 856(c)(2), (3), and (4) of the Code, the term "gross income" has the same meaning as that term has under section 61 and the regulations thereunder.

The legislative history underlying the tax treatment of REITs indicates that the central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-823 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

Section 61(a) of the Code provides that, except as otherwise provided, gross income includes all income from whatever source derived.

Section 1.61-12(c)(1) of the regulations provides that an issuer does not realize gain or loss upon the issuance of a debt instrument. Section 1275(a)(1)(A) of the Code defines a debt instrument as a bond, debenture, note, or certificate or other evidence of indebtedness.

Section 1.163-13(c) of the regulations defines "bond issuance premium" as the excess, if any, of the issue price of a debt instrument over its stated redemption price at maturity.

## **CONCLUSION**

Bond issuance premium on the Premium Notes will not be treated as other than qualifying income for purposes of the gross income tests under sections 856(c)(2) and (c)(3).

Except as expressly provided herein, no opinion is expressed concerning any federal income tax consequences related to the facts herein under any other provisions of the Code. Specifically, no opinion is expressed or implied as to whether the Notes are debt instruments to which section 1272(a)(6) applies or as to the reasonableness of Taxpayer's method of accounting for bond issuance premium or whether such method clearly reflects income. Furthermore, we express no opinion as to whether Taxpayer qualifies as a REIT, whether Subsidiary qualifies as a qualified REIT subsidiary under part II of subchapter M of the Code, or whether Trust is properly classified as a taxable mortgage pool pursuant to section 7701(i) of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations that are inconsistent with any conclusion in the ruling. See section 11.04 of Rev. Proc. 2007-1, 2007-1 I.R.B. 1, 49. However, a private letter ruling is not generally revoked or modified retroactively if the taxpayer can demonstrate that the criteria in section 11.08 of Rev. Proc. 2007-1 are satisfied.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives. A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

David B. Silber  
David B. Silber  
Senior Technician Reviewer, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)